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March 16, 1998

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Re: Docket No. RE-0000-C-94-0165

Dear Sir or Madam:

During the Stranded Cost hearings of February 23, 1998, all parties were directed to file their briefs on or before 4:00 P.M. on March 16, 1998. Enclosed are the briefs for Arizona Public Service Company.

If you have any questions, please contact me at 250-1031.

Sincerely,

Barbara A. Klemstine
Manager
Regulatory Affairs

BAK/JKD/pb

Enclosures

Arizona Corporation Commission

DOCKETED

MAR 16 1998

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For Parties of Record in Docket No. RE-0000-C-94-0165

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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
COMMISSIONER - CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF) DOCKET NO. RE-00000-C-94-1065
COMPETITION IN THE)
PROVISION OF ELECTRIC)
SERVICES THROUGHOUT THE)
STATE OF ARIZONA)

INITIAL BRIEF OF
ARIZONA PUBLIC SERVICE COMPANY
ON GENERIC STRANDED COST
ISSUES

March 16, 1998

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
COMMISSIONER - CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF) DOCKET NO. RE-00000-C-94-1065
COMPETITION IN THE)
PROVISION OF ELECTRIC)
SERVICES THROUGHOUT THE)
STATE OF ARIZONA)

Pursuant to the Presiding Officer's direction herein, Arizona Public Service Company ("APS" or "Company") hereby submits its Initial Brief on certain of the generic stranded costs issues addressed by the Company's witnesses in this proceeding. As requested by the Presiding Officer, APS' Initial Brief is divided into two (2) sections: (1) the Company's responses to the questions posed in the Procedural Orders of December 1 and December 12, 1997 ("December Procedural Orders"); and (2) a legal brief.

I. APS' RESPONSES TO THE ISSUES PRESENTED IN THE DECEMBER PROCEDURAL ORDERS.

A. Should the Electric Competition Rules ("Rules") Be Modified Regarding Stranded Costs, if so How?

APS proposes that the Rules be modified to clarify several ambiguities and potential inequities created by the literal language of certain portions of the Rules. A complete mark-up of APS' proposed changes to the Rules was attached to the Direct

1 Testimony of Jack E. Davis as Schedule JED-4 and is attached
2 hereto as Exhibit "A", and incorporated herein by reference.
3 Additionally, APS' proposals with regard to mitigation are more
4 specifically set forth later in this Initial Brief.

5 **1. The Commission Must Clarify the Definition of**
6 **"Stranded Costs" and, Correspondingly, the**
7 **Definition of "System Benefits" With Regard to**
8 **Nuclear Fuel Disposal Costs.**

9 The Commission has recognized that nuclear decommissioning
10 costs are recoverable through the System Benefits Charge ("SBC").
11 Nuclear fuel disposal costs are an inherent part of nuclear
12 decommissioning costs. Both represent sunk costs that can no
13 longer be meaningfully mitigated and for which complete assurance
14 of full funding is in the public interest. See e.g., 8 Tr. 2709-10
15 (R. Smith); 10 Tr. 3074-75 (K. Rose); Ex. APS-8 (J. Davis
16 Testimony), at 15. Accordingly, the Commission should also
17 require that nuclear fuel disposal costs be recovered through the
18 SBC. This would be accomplished by amending Rule 1608 to
19 specifically include the recovery of nuclear fuel disposal costs
20 in the SBC, as noted in Schedule JED-4.

21 **2. The Commission Must Clarify the Definition of**
22 **Stranded Costs to Include Post-1996 Stranded Costs.**

23 The Commission must recognize that the inclusion of post-1996
24 stranded costs in the definition of "stranded costs" is
25 appropriate. For example, APS witness Dr. John Landon testified:

26 Q. Are there ongoing costs that should be
included with stranded costs?

A. Yes. Any prudent investment made or cost
incurred during the regulatory regime must be considered

1 when evaluating stranded costs. Regardless of when the
2 decision to make the transition is made or when the
3 transition to competition is initiated, all prudently
4 incurred costs of the regulated utility should be
5 collectable. For example, incumbent utilities may
6 continue to bear the obligation to serve some or all
7 consumers for some period after the introduction of
8 retail access. This may cause additional stranded costs
9 if prices in effect during the transition period are
10 insufficient to recover these costs. Incumbents may
11 also be obliged to provide system reliability services.
12 Their provision may or may not be fully compensated by
13 rates in effect. Furthermore, many incumbent utilities
14 face unavoidable (and potentially unrecoverable) costs
15 on an ongoing basis to meet their obligations under
16 existing regulation. Although the burden of
17 demonstrating what costs should be eligible for recovery
18 lies with the utility, regulators must be careful to
19 ensure that the process of identifying and recovering
20 stranded costs includes not only those costs incurred
21 prior to the decision to introduce competition, but also
22 those prudent costs incurred as result of existing
23 regulatory obligations or as part of the transition to
24 competition.

25 Ex. APS-4 (J. Landon Rebuttal Testimony) at 6.

26 Virtually every witness in this proceeding expressing an
opinion on this subject agreed that at least some post-1996 costs
should be fairly included as stranded costs. See, e.g., 6 Tr. 2110
(A. Propper); 8 Tr. 2726-27 (R. Smith); 13 Tr. 4212-13
(D. Nelson). For example, the cost of establishing an Independent
System Operator would result in uncompensated costs to those
utilities involved in its formation. Future capital expenditures
made by an Affected Utility to meet its standard offer
requirements may become stranded. Hardware and software for
metering and billing, including both existing infrastructure and,
potentially, future requirements, could generate stranded costs.
Employee transition expenses may result in additional stranded

1 costs. In addition, and again under a literal reading of the
2 current Rules, post-1996 costs incurred pursuing mitigation
3 strategies and establishing the valuation of stranded costs,
4 including costs of auctions or asset sales,¹ would be subject to
5 challenge. For these reasons, the Commission should expressly
6 recognize that it is inappropriate to have an arbitrary 1996 cut-
7 off date for consideration of stranded costs.

8 **3. The Commission Must Clarify the Permissible Classes**
9 **of Customers and Services Through Which Affected**
10 **Utilities May Recover Stranded Costs.**

11 The first sentence of Subsection J of R14-2-1607 currently
12 states that stranded costs may only be recovered from competitive
13 power purchases. This can be read in either of two ways, neither
14 of which was supported by any of the witnesses appearing in this
15 matter. The first is that stranded costs can only be recovered in
16 the price of competitive generation. Because, by definition,
17 stranded costs are those costs that cannot be mitigated or
18 recovered in competitive generation prices, this would be
19 tantamount to saying "no stranded cost recovery." This would make
20 the first sentence of Subsection J inconsistent with Subsections B
21 and H, which both provide for the recovery of stranded costs and
22 indicate that such recovery can be through charges imposed on non-
23 competitive services. The second possible interpretation is that
24 "stranded costs" can only be recovered from customers choosing
25 competitive generation service. This would clearly be

26 ¹ This would also include costs to secure various
regulatory and creditor/shareholder approvals.

1 discriminatory and anti-competitive.

2 Although customers remaining on standard offer service may
3 not see a transition change appear on their utility bill, stranded
4 cost recovery is, of course, implicit in standard offer service.
5 To prevent any argument that standard offer service cannot
6 implicitly include stranded cost recovery, the "competitive
7 market" limitation in Subsection J should be deleted. This was a
8 consensus finding of both the Stranded Cost and Legal Issues
9 Working Groups. See Legal Issues Working Group Report at 22;
10 Stranded Cost Working Group Report at 44, 47.

11 Some witnesses have proposed tinkering with the sentence in
12 question. See, e.g., Ex. Tuc-1 (E. Coyle Testimony) at 9-10; Ex.
13 RUCO-1 (R. Rosen Testimony) at 81. However, these changes either
14 do not resolve the problems identified above or create yet
15 additional ambiguities. APS strongly recommends a simple
16 straightforward deletion of this language.²

17 **B. When Should "Affected Utilities" Be Required to Make a**
18 **"Stranded Cost" Filing Pursuant to A.A.C. R14-2-1607?**

19 Under APS' proposal, no all-encompassing total stranded cost
20 filing is ever required. Rather, the Company would submit an
21 annual stranded cost filing covering only the stranded costs of
22 the prior year. The first filing (for 1999 stranded cost
23 calculations) could be submitted within 30 days of the final order

24
25 ² APS does not object to the balance of Subsection J with the
26 understanding that it would not prevent the assessment of stranded
cost recovery on backup, supplemental, and/or capacity-related
ancillary services provided to such customers.

1 in this proceeding.

2 **C. What Costs Should Be Included as Part of "Stranded**
3 **Costs" and How Should Those Costs Be Calculated?**

4 **1. APS' Regulatory Assets.**

5 For APS, recovery of its regulatory assets has already been
6 ordered by the Commission in Decision No. 59601. That 1996 Rate
7 Settlement specifically identified APS' regulatory assets and
8 ordered them amortized and collected in rates by 2004.
9 Accordingly, cost recovery for APS' regulatory assets has already
10 been assured, and these regulatory assets need not be reconsidered
11 in a stranded cost proceeding. APS noted a general consensus from
12 the various witnesses in support of continued full recovery of
13 regulatory assets, even from those witnesses generally opposed to
14 full recovery of other stranded costs. See, e.g., 10 Tr. 3085-86
15 (K. Rose); 8 Tr. 2500-01 (M. Cooper). Because of the unique
16 vulnerability of such assets to even the mildest degree of
17 regulatory uncertainty, the final order in this proceeding should
18 clearly reaffirm the Commission's commitment to Decision No. 59601
19 and to the full recovery of regulatory assets.

20 **2. Net Lost Revenues Approach to Stranded Cost**
21 **Calculation.**

22 To calculate stranded costs, APS proposes a methodology that
23 is similar to the net lost revenues approach widely used by other
24 parties and in other jurisdictions. However, the APS proposal
25 avoids the forecasting errors and contentious speculation inherent
26 in other applications of the net lost revenues method. APS'
methodology compares the actual market price for generation (as

1 established by the California Power Exchange or some other
2 comparable market index), with the Company's actual generation
3 cost. Thus, at the end of each year of the transition period, APS
4 would subtract the total market price for generation from the
5 total cost of power supply service. No forecasting (other than an
6 estimate of market price for 1999, the first year) is involved.
7 The stranded costs so calculated are then apportioned among the
8 appropriate customer classes based on traditional cost allocation
9 and rate design principles and recovered during the ensuing year
10 through the transition charge. A summary of this methodology is
11 set forth in the direct testimony of Jack E. Davis as Schedule
12 JED-2, attached hereto as Exhibit "B" and incorporated herein by
13 reference.

14 The APS approach has significant advantages for stranded cost
15 calculations over other methods. First, it inherently nets out
16 so-called "stranded benefits" with "stranded costs" because all of
17 the utility's generation assets are included in the calculation.
18 Second, it avoids further increasing stranded costs by the costs
19 of appraisals, engineering studies of replacement costs, etc. The
20 most significant problem with other generic net lost revenues
21 approaches is that they attempt to calculate stranded costs over
22 the remaining life of the generation assets (which could be
23 decades) and involve inevitable and likely significant forecasting
24 errors, both with regard to the market price of generation and
25 future cost of generation. These approaches also postpone for
26 that same lengthy period the charging of true market prices for

1 generation. Those difficulties, however, are obviated in APS'
2 plan, in that actual market prices and cost are used and a
3 transition charge assessed only during the transition period.

4 **D. Should There Be a Limitation on the Time Frame Over**
5 **Which "Stranded Costs" are Calculated?, and**

6 **E. Should There Be a Limitation on the Recovery Time Frame**
7 **for "Stranded Costs?"**

8 Under APS' proposal, both the calculation and recovery time
9 periods are essentially merged together. APS firmly believes that
10 a limitation on the time allotted for both calculating and
11 recovering stranded costs is important. Arizona should transition
12 from traditional cost of service regulation to full competition in
13 the price of electric generation and other related services as
14 quickly as possible.

15 APS believes that stranded costs will, for the most part,
16 result from the oversupply of capacity and energy in the Western
17 Systems Coordinating Council ("WSCC"). Oversupply will keep the
18 market price for generation below the long-run marginal cost
19 ("LRMC") of generation until at least 2006.

20 As competition in generation displaces regulation across the
21 WSCC, the imbalance of capacity and energy will likely diminish.
22 However, there is certainly no guarantee that the market imbalance
23 in the WSCC will correct by 2006, the end of the transition period
24 proposed by APS. Moreover, although such correction should cause
25 market prices to increase, it may still be some time before price
26 equals LRMC and, even then, ongoing technological improvements
(such as we have seen in the past decade), the availability of

1 hydro, continued low natural gas prices, and improved transmission
2 availability may serve to drive down LRMC over time. Nonetheless,
3 because APS believes that a complete transition to competitive
4 generation should be concluded as soon as is practically feasible,
5 APS would not seek to extend the eight-year transition period even
6 should the oversupply in the WSCC market remain after the
7 transition period.

8 Finally, if the market imbalance in the WSCC were to correct
9 prior to 2006, the early correction would not result in an
10 overrecovery of stranded costs. Under the Rules, all customers
11 have the ability to move between competitive and standard offer
12 service throughout the transition period. If the market price for
13 generation exceeds the LRMC, customers are protected from the
14 higher market price by moving to the cost-based standard offer.

15 **F. How and Who Should Pay for "Stranded Costs" and Who, if**
16 **Anyone, Should Be Excluded From Paying for Stranded**
Costs?

17 All end users receiving regulated services from APS should
18 pay for stranded costs. Those customers taking competitive
19 generation will pay via a Stranded Cost Recovery Charge ("SCRC")
20 that is applied as a distribution charge, and those on standard
21 offer pay the SCRC through their regulated rates. The SCRC must
22 be a nonbypassable wires charge for stranded cost recovery to be
23 competitively neutral. Further, the SCRC would be specific to
24 each Affected Utility, but applicable to all customers on the
25 pertinent distribution system. The SCRC would be allocated among
26 customer classes on a demand and/or energy basis (whichever is

1 applicable to the class) under standard rate design principles.

2 Self-generators and interruptible power customers, however,
3 should also pay for at least some stranded cost recovery. These
4 customers receive backup power, synchronizing power or other
5 ancillary services that require generation assets to be in place
6 and operational. Interruptible customers receive electric power
7 from generation assets and should pay for stranded costs
8 associated with these assets. Put simply, whether or not an APS
9 customer's regulated generation services are interruptible does
10 not alter the fact that they receive generation from APS
11 generation assets.

12 **G. Should There Be a True-Up Mechanism and, if so How Would**
13 **it Operate?**

14 The only "true-up" mechanism necessary under APS' methodology
15 involves the one-time estimate of market price for 1999. That
16 estimate can be trued up to reflect the actual market prices for
17 the year. Indeed, the use of actual market data and actual cost
18 of service in APS' proposal makes the mechanism self-correcting
19 and thus prevents the need for periodic true-ups throughout the
20 remainder of the proposed transition period to correct for market
21 price and generation cost forecasting errors.

22 Moreover, APS' proposal for annual adjustments will
23 automatically reflect any increases in the "volume" of service
24 being provided to reflect changes in the number of customers and
25 use per customer. This volumetric adjustment, although again not a
26 retroactive "true up," enhances the self-correcting nature of the

1 Company's method and would prevent any systematic overcollection
2 or undercollection of stranded costs during the transition period.

3 **H. Should There Be Price Caps or a Rate Freeze as Part of**
4 **the Development of a Stranded Cost Recovery Program and**
5 **if so, How Should it Be Calculated?**

6 APS doubts the legality of any Commission-imposed rate freeze
7 or price cap. Moreover, APS has not made any voluntary proposal
8 for such a "freeze" or "cap" at this time.

9 **I. What Factors Should Be Considered for "Mitigation" of**
10 **Stranded Costs?**

11 **1. The Commission Must Limit the Scope of Required**
12 **Mitigation to Revenue Enhancements and Cost**
13 **Reductions Reasonably Achievable During the**
14 **Stranded Cost Recovery Period.**

15 The Commission's definition of "mitigation" must abandon a
16 nonsensical and perfectionist *requirement* that "every feasible"
17 mitigation effort be undertaken by an Affected Utility. A legal
18 and practical approach would require that an Affected Utility take
19 "reasonable" mitigation efforts. This is the commercially
20 accepted standard of contract damage mitigation and one for which
21 there is ample legal precedent and judicial construction to guide
22 the Commission.

23 An "every feasible" requirement, when taken to the extreme,
24 imposes an impossible standard for Affected Utilities to meet.
25 For example, it could suggest that the Commission must perform an
26 after-the-fact evaluation that weighs every potential mitigation
option actually considered and/or implemented against the
opportunity costs of a literally infinite number of alternative
options. It also requires a crystal ball for the Commission to

1 conclude how each one of the infinite number of these foregone
2 alternatives would have turned out. The "every feasible" analysis
3 also presents potential cross-subsidy issues that will raise
4 challenges from non-utility competitors. Ultimately, the "every
5 feasible" requirement provides an incentive for utilities to
6 pursue high-risk/high reward ventures in an effort to meet this
7 impossibly high standard. Further, as Dr. Heironymus noted,
8 "[s]uch a requirement would carry with it a ratepayer
9 responsibility to cover any losses of such businesses." Ex. APS-2
10 (W. Heironymus Testimony) at 22. Rather than fall victim to a
11 quagmire of "Monday-morning quarterbacking," the Commission should
12 require "reasonable" mitigation efforts on the part of Affected
13 Utilities.

14 In addition, the Commission should delete the requirement
15 that mitigation include "offering a wider scope of services for
16 profit." Stranded costs involved in this proceeding are
17 generation-related stranded costs; imputing any profits from a
18 nonregulated or affiliate service to offset generation-related
19 stranded cost recovery is tantamount to denying the recovery of
20 those stranded costs to the affected utility. Accordingly, APS
21 proposes that Rule 1607 be reworded to clarify that mitigation
22 measures are limited to regulated utility services and purchased
23 power costs.

24 Finally, the Commission should not attempt to mask what is
25 actually a disallowance of stranded costs by setting unachievable
26 goals for cost mitigation. For example, no one can seriously

1 believe (and no witness so testified) that 50% or more of stranded
2 costs can be recovered through further mitigation during the
3 transition period. Such an action combines the rank regulatory
4 opportunism that is at the heart of all "sharing" proposals with
5 the equally undesirable traits of being at best disingenuous and
6 at worse downright deceitful.

7 **2. The Commission Must Recognize Past Efforts at Cost**
8 **and Price Reduction.**

9 APS and other utilities have aggressively reduced costs in
10 preparation for competition, and prices have accordingly been
11 reduced as well. APS will request an additional price reduction
12 this year. To ignore these cost reductions in evaluating required
13 mitigation efforts - reductions already attributable to
14 competition and already credited to customers - will again result
15 in an after-the-fact disallowance of legitimate stranded cost
16 recovery, and will penalize the Affected Utilities for mitigation
17 efforts undertaken prior to 1999. During the Company's
18 examination of Mr. Higgins, it was demonstrated that failure to
19 take prior cost reductions into consideration actually penalized
20 the more efficient utility and rewarded the less efficient utility
21 - certainly an anomalous and unfair result. 13 Tr. 4169
22 (K. Higgins).

23 **J. What are the FASB No. 71 Implications Resulting From the**
24 **Company's Recommended Calculation and Recovery**
25 **[Methodology]?**

26 There are no immediate Financial Accounting Standard ("FAS")
No. 71 implications to APS' proposed method of calculating and

1 recovering stranded costs. APS agrees with the testimony of all
2 the witnesses addressing this issue: The central concern with FAS
3 71 is that accounting write-down or write-off requirements may be
4 triggered if the Commission denies or casts doubt on stranded cost
5 recovery. Accounting write offs or write downs triggered by a
6 Commission decision may have an immediate and devastating impact
7 on some of the utilities involved (such as triggering debt
8 covenants or causing insolvency), even if the decision itself
9 contemplated less drastic or less immediate "regulatory" results.

10 **K. [What Are the] Assumptions Made Including Any**
11 **Determination of Market Price?**

12 APS believes that a stranded cost calculation methodology
13 should avoid or minimize future market price assumptions. The
14 methodology proposed by APS does not require assumptions about
15 market prices for generation because it would use accepted indices
16 of such prices during an historical period of time. These indices
17 reflect an average of thousands of actual arms' length market
18 transactions each hour of the year.

19 Several parties to this proceeding have attempted to confuse
20 what should be a simple issue: To what market is the Commission
21 referring? Clearly, the relevant market for stranded cost
22 calculation is the bulk power market. The difference between
23 "wholesale" and "retail" in electric power is an outdated legal
24 distinction, not an economic one.

25 To be sure, there is a difference between the competitive
26 price of generation and the final retail price of electricity.

1 Between the busbar and the meter are transmission and distribution
2 entities and possibly retail marketers. Each has its own costs of
3 doing business, including capital costs - costs that will impact
4 the "all in" price of electricity to end users. However, the
5 electric producer's profit or loss on electric generation itself
6 will be established in the bulk power market.

7 Dr. William H. Heironymus addressed this very issue in his
8 Rebuttal Testimony:

9 Q. Please turn now to what you have termed the
10 retail rate issue. Please explain this issue.

11 A. This issue arises in two contexts. The first
12 is the argument that paying stranded generating costs
13 will inhibit competition to provide electricity to
14 retail customers. The second made by Dr. Rosen and Mr.
15 Rose among others, is that in measuring stranded cost
16 the appropriate market price comparison is to the retail
17 price.

18 Both arguments are absolutely wrong. They are
19 wrong because of a failure to ask the simplest of all
20 questions: what is the product or service that we are
21 talking about when discussing or measuring stranded
22 generating costs? *The competitive service at issue is*
23 *the production of wholesale electricity, not the sale of*
24 *electricity to retail consumers.* Most of the erroneous,
25 even silly, arguments about predation miss this simple
26 fact. To repeat, generation produces only bulk power,
not retail sales. If a CTC fully compensates for the
difference between the generation-related costs that the
utility would have recovered under continued regulation
and the *wholesale* market price, this does not give the
utility an unfair advantage in competing for retail
load.

The error made by some of these witnesses may arise
from a failure to distinguish between the calculation of
stranded cost and the setting of the "allowance" or
"buy-through rate" that reduces the bundled service rate
of a customer that elects service from a competitive
retailer. I agree that the buy-through rate should be
sufficient to cover not only the retailers costs of
buying at the wholesale market price, but also the

1 competitive costs of the retailing function itself. A
2 buy-through rate that fails to do this could conceivably
3 affect the pace of retail competition. However, a
4 utility generator *does not and cannot* earn retail
5 margins. The ACC has determined, quite correctly, that
6 generation and retailing are separate businesses and has
7 required unbundled accounts. Arizona utilities may, or
8 may not, make money as retailers. The fortunes of the
9 retailing business have absolutely nothing whatsoever to
10 do with the stranded cost of generation, nor with the
11 effect of generation stranded cost recovery on retail
12 competition.

13 Ex. APS-3 (W. Heironymus Rebuttal Testimony) at 16-17.

14 In its examination of Mr. Nelson, APS attempted to make this
15 same point through an analogy to the natural gas business, where
16 natural gas prices at the burner tip (which reflect the costs of
17 transmission, distribution, and retail marketing) do not affect
18 the profit or loss of the gas producer at the wellhead. See 13
19 Tr. 4223 (D. Nelson). Perhaps an easier analogy is the New York
20 Stock Exchange. There is no "wholesale" as opposed to "retail"
21 market for stock nor are the terms "long term" versus "short term"
22 particularly relevant to determining the market price of the stock
23 itself. Parties wanting to "lock in" a certain price for stocks
24 for a specific period of time do so with other financial
25 instruments such as options or straddles.

26 **II. APS' LEGAL ANALYSIS OF SELECTED STRANDED COST ISSUES.**

APS will address only two (2) legal issues in this portion of
its Initial Brief. However, the Company reserves the right to
respond to any legal issue raised by other parties in their
opening briefs.

1 **A. The Commission Lacks the Authority to Order Divestiture.**

2 Public utility commissions in jurisdictions which have
3 addressed this issue have expressly recognized that a state
4 commission lacks the authority to compel a public service
5 corporation to divest assets.³ See, e.g., *Re Elec. Ind.*
6 *Restructuring* 163 P.U.R.4th 96, at n.31 (Mass. D.P.U. 1995)
7 ("While the Department has the authority to approve the voluntary
8 divestiture of assets from one electric company to another...there
9 is no explicit statutory authority by which the Department may
10 order divestiture, nor is it likely to be implied."); *Carmel Mtn.*
11 *Ranch v. San Diego Gas & Elec. Co.*, 1988 Cal. P.U.C. LEXIS 67 at
12 *14-15 (Mar. 9, 1988). Indeed, in *Carmel Mountain Ranch*, the
13 California commission stated:

14 We have found no case or statute that confers on the
15 Commission the power to compel a public utility to sell
16 and convey an interest in real property to another
17 person or entity or to determine the price or terms of
the sale.... We do not know of any judicial decision or
any of our own decisions or orders that would support
the exercise of such powers.

18 1988 Cal. P.U.C. LEXIS at *14-15.⁴ See also *Application of Would-*

19 _____
20 ³ That there is little Arizona authority on point is
21 undoubtedly due to the unprecedented nature of the assertion that
22 the Commission has the authority to order the divestiture of
generation plant in the exercise of its regulatory ratemaking
power.

23 ⁴ *Carmel Mountain Ranch* cited *Hanlon v. Eshleman*, 146 P.
24 656 (Cal. 1915) as confirmation of the commission's lack of power
25 to compel a sale. In *Hanlon*, the California Supreme Court held
26 that "[i]f the owner [of a utility] does not desire to sell, the
commission cannot compel him to do so." *Id.* at 657. *Hanlon's*
analysis of commission authority regarding utility property sales
was adopted by the Arizona Supreme Court in 1948. *Trico Elec.*
Coop. v. Ralston, 67 Ariz. 358, 364, 196 P.2d 470, 473 (1948)

1 *Be Buyers of Gray Line*, 1976 Cal. P.U.C. LEXIS 35 (Dec. 21, 1976),
2 at *2-*3 nn.1-2 (holding that public utility commission lacks the
3 authority to compel public service corporation to sell assets).

4 This result - that the Commission cannot make the ultimate
5 imposition and force public service corporations from an entire
6 line of business in an attempt to ease regulatory burdens - is
7 entirely consistent with long-settled precedent in Arizona. In
8 *Southern Pacific Co. v. Corporation Commission*, 98 Ariz. 339, 404
9 P.2d 692 (1965), the Arizona Supreme Court held that the
10 Commission could not order a regulated railway to continue service
11 on one of its lines without finding that the railway's service was
12 inadequate. Noting the conflict between regulation and the rights
13 of management, the Court quoted the controlling United States
14 Supreme Court precedent:

15 [P]lainly it is not the purpose of regulatory bodies to
16 manage the affairs of the corporation. "It must never
17 be forgotten that, while the state may regulate with a
18 view to enforcing reasonable rates and charges, it is
not the owner of the property of public utility
companies, and is not clothed with the general power of
management incident to ownership."

19 *Id.* at 343, 404 P.2d at 694 (quoting *Missouri ex rel. Southwestern*
20 *Bell Tel. Co. v. Public Serv. Comm'n*, 262 U.S. 276, 289, 43 S. Ct.
21 544, 547, 67 L. Ed. 981 (1923)).

22
23
24
25 _____
26 (holding that, as in *Hanlon*, the Commission lacks jurisdiction to
enforce or construe a contract for the sale of utility property;
it merely has the authority to approve or disapprove the sale).

1 **B. Any Disallowance of a Percentage of Stranded Cost**
2 **Recovery to Effect a "Sharing" Between APS' Shareholders**
3 **and Consumers Would Be Arbitrary and Capricious.**

4 Both Staff and the Commission have previously addressed the
5 issue of whether an Affected Utility would have an opportunity to
6 fully recover its stranded costs. Indeed, the Commission
7 unanimously adopted Rules which, in its own words, "guaranteed"
8 full recovery of net unmitigated stranded costs. No party has
9 legally challenged the Commission's previous determination to
10 allow full recovery. No party has offered the slightest legal
11 reason for departing from this prior determination.

12 In contrast, APS witnesses noted that an opportunity for full
13 stranded cost recovery is economically efficient, equitable,
14 lawful, and in the final analysis, practical if one wishes to
15 hasten the introduction of full competition:

16 Q. Several witnesses have argued against full
17 stranded cost recovery. Why should utilities be allowed
18 to recover their stranded costs?

19 A. A number of legal and economic arguments
20 justify compensating a utility for its stranded costs,
21 including 1) the promotion of economic efficiency; 2)
22 the regulatory compact and the unique nature of
23 regulated industries; 3) fairness and capital cost
24 concerns about the lack of advance warning or investor
25 compensation and 4) the hastening of retail competition.

26 Ex. APS-4 (J. Landon Rebuttal Testimony) at 7.

 It is important to note that in the case of APS, all of its
potentially strandable costs have been found reasonable by the
Commission and are presently in rates and will continue to be
recovered through the standard offer. Moreover, the APS proposal
for recovery of stranded costs does not contemplate any

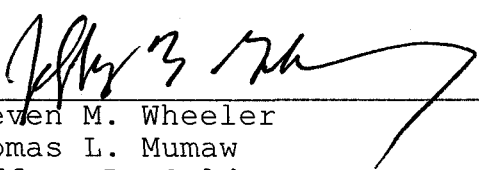
1 acceleration in the recovery of such costs. No party has provided
2 a reasoned explanation of why the Commission's unilateral decision
3 to move toward competition should now somehow result in these same
4 reasonable costs being effectively disallowed.

5 **III. CONCLUSION**

6 For the reasons set forth above, APS requests that the
7 Commission adopt APS' stranded cost calculation and recovery
8 methodology, and modify the Competition Rules as provided in APS'
9 filed testimony and this Initial Brief. APS has offered a stranded
10 cost recovery proposal that is straightforward, does not rely on
11 mere speculation and conjecture, and which transitions Arizona to
12 fully competitive generation prices. Moreover, the APS proposal
13 does not increase stranded costs and is equitable and lawful, unlike
14 forced divestiture and the various "sharing" schemes, which are
15 nothing but confiscation under a different name.

16 RESPECTFULLY SUBMITTED this 16th day of March, 1998.

17 SNELL & WILMER L.L.P.

18
19 
20 Steven M. Wheeler
21 Thomas L. Mumaw
22 Jeffrey B. Guldner

23 Attorneys for
24 Arizona Public Service Company
25
26

471687.04

CERTIFICATE OF SERVICE

The original and ten (10) copies of the foregoing document were filed with the Arizona Corporation Commission on this 16th day of March, 1998, and service was completed by mailing or hand-delivering a copy of the foregoing document this 16th day of March, 1998, to all parties of record herein.

James K. Ringer

Snell & Wilmer

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Exhibit A

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SCHEDULE JED-4

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R14-2-1601. Definitions

8. "Stranded Cost" means the verifiable net difference between:

- a. The ~~value~~ COST of all the prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchased power contracts, fuel contracts, and regulatory assets) ~~acquired or entered into prior to the adoption of this Article.~~ under traditional regulation of Affected Utilities; and
- b. The market value of those assets and obligations directly attributable to the introduction of competition under this Article.

R14-2-1607. Recovery of Stranded Cost of Affected Utilities

- A. The Affected Utilities shall take ~~every feasible~~ REASONABLE, cost-effective measures DIRECTLY RELATED TO REGULATED UTILITY SERVICES to mitigate or offset Stranded Cost by means such as expanding wholesale or retail markets, ~~or offering a wider scope of services for profit, among others~~ OR REDUCING GENERATION PURCHASED POWER COSTS.
- B. The Commission shall allow recovery of unmitigated Stranded Cost by Affected Utilities.
- C. A working group to develop recommendations for the analysis and recovery of Stranded cost shall be established.
 1. The working group shall commence activities within 15 days of the date of adoption of this Article.
 2. Members of the working group shall include representatives of staff, the Residential Utility Consumer Office, consumers, utilities, and other Electric Service Providers. In addition, the Executive and Legislative Branches shall be invited to send representatives to be members of the working group.
 3. The working group shall be coordinated by the Director of the Utilities Division of the Commission or by his or her designee.
- D. In developing its recommendations, the working group shall consider at least the following factors:
 1. The impact of Stranded Cost recovery on the effectiveness of competition:
 2. The impact of Stranded Cost recovery on customers of the Affected Utility who do not participate in the competitive market:
 3. The impact, if any, on the Affected Utility's ability to meet debt obligations:

SCHEDULE JED-4

(Page 2 of 4)

4. The impact of Stranded Cost recovery on prices paid by consumers who participate in the competitive market:
 5. The degree to which the Affected Utility has mitigated or offset Stranded Cost:
 6. The degree to which some assets have values in excess of their book values:
 7. Appropriate treatment of negative Stranded Cost:
 8. The time period over which such Stranded Cost charges may be recovered. The Commission shall limit the application of such charges to a specified time period:
 9. The ease of determining the amount of Stranded Cost:
 10. The applicability of Stranded Cost to interruptible customers.
 11. The amount of electricity generated by renewable generating resources owned by the Affected Utility.
- E. The working group shall submit to the Commission a report on the activities and recommendations of the working group no later than 90 days prior to the date indicated in R14-2-1602.
- F. The Commission shall consider the recommendations and decide what actions, if any, to take based on the recommendations.
- G. The Affected Utilities shall file estimates of unmitigated Stranded Cost. Such estimates shall be fully supported by analyses and by records of market transactions undertaken by willing buyers and willing sellers.
- H. An Affected Utility shall request Commission approval of distribution charges or other means of recovering unmitigated Stranded Cost from customers who reduce or terminate service from the Affected Utility as a direct result of competition governed by this Article, or who obtain lower rates from the Affected Utility as a direct result of the competition governed by this Article.
- I. The Commission shall, after hearing and consideration of analyses and recommendations presented by the Affected Utilities, staff, and intervenors, determine for each Affected Utility the magnitude of Stranded Cost, and appropriate Stranded Cost recovery mechanisms and charges. In making its determination of mechanisms and charges, the Commission shall consider at least the following factors:
1. The impact of Stranded Cost recovery on the effectiveness of competition:
 2. The impact of Stranded Cost recovery on customers of the Affected Utility who do not participate in the competitive market:

SCHEDULE JED-4

(Page 3 of 4)

3. The impact, if any, on the Affected Utility's ability to meet debt obligations;
4. The impact of Stranded Cost recovery on prices paid by consumers who participate in the competitive market;
5. The degree to which the Affected Utility has mitigated or offset Stranded Cost;
6. The degree to which some assets have values in excess of their book values;
7. Appropriate treatment of negative Stranded Cost;
8. The time period over which such Stranded Cost charges may be recovered. The Commission shall limit the application of such charges to a specified time period;
9. The ease of determining the amount of Stranded Cost;
10. The applicability of Stranded Cost to interruptible customers;
11. The amount of electricity generated by renewable generating resources owned by the Affected Utility.

J. ~~Stranded Cost may only be recovered from customer purchases made in the competitive market using the provisions of this Article.~~ Any reduction in electricity purchases from an Affected Utility resulting from self-generation, demand side management, or other demand reduction attributable to any cause other than the retail access provisions of this Article shall not be used to calculate or recover any Stranded Cost from a consumer.

K. The Commission may order an Affected Utility to file estimates of Stranded Cost and mechanisms to recover or, if negative, to refund Stranded Cost.

L. The commission may order regular revisions to estimates of the magnitude of Stranded Cost.

R14-2-1608. System Benefits Charges

A. By the date indicated in R14-2-1602, each Affected Utility shall file for Commission review non-bypassable rates or related mechanisms to recover the applicable pro-rata costs of System Benefits from all consumers located in the Affected Utility's service area who participate in the competitive market. In addition, the Affected Utility may file for a change in the System Benefits charge at any time. The amount collected annually through the System Benefits charge shall be sufficient to fund the Affected Utilities' present Commission-approved low income, demand side management, environmental, renewables, and nuclear power plant decommissioning AND NUCLEAR FUEL DISPOSAL programs.

B. Each Affected Utility shall provide adequate supporting documentation for its proposed rates for System Benefits.

SCHEDULE JED-4

(Page 4 of 4)

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- 3 C. An Affected Utility shall recover the costs of System Benefits only upon hearing and
4 approval by the Commission of the recovery charge and mechanism. The Commission
5 may combine its review of System Benefits charges with its review of filings pursuant to
6 R14-2-1606.
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- D. Methods of calculating System Benefits charges shall be included in the workshops
described in R14-2-1606(1).

Exhibit B

1 SCHEDULE JED-2

2 APS STRANDED COST METHODOLOGY

3 Four Step Approach to Calculate Stranded Cost Recovery Charge ("SCRC") for APS

4
5 • **STEP 1 Determination of Hourly Market Prices.**

6 Market prices will be determined by reference to the California PX market in dollars per
7 MWH for the Southern California Hub as adjusted for:

- 8 1. Transmission wheeling (if any)
9 2. Administrative charges by the ISO/PX.
10 3. Transmission losses

11 This hourly price is the Market Price at Palo Verde.

12 • **STEP 2 Determination of APS Retail Market Revenues.**

13 Actual hourly loads are multiplied by hourly market price from Step 1 to determine hourly
14 revenues which could have been produced if APS were to sell its power supply in the
15 competitive market. Summation of this hourly dollar value across daily / monthly / annual
16 hours produces annual revenues.

17 • **STEP 3 Determination of the Actual Power Supply Costs.**

18 The actual costs will be obtained from relevant financial and accounting data. Examples of
19 the costs include:

- 20 1. Fuel costs
21 2. Purchased power costs
22 3. O&M Costs including A&G allocation
23 4. Depreciation expenses
24 5. Interest expenses
25 6. Taxes (other than income)
26 7. Common and preferred shareholder equity expenses and
8. State and Federal Income taxes.

• **STEP 4 Calculation of the SCRC.**

If the amount of APS costs (Step 3) is greater than APS Retail Market Revenues (Step 2),
the difference will then be allocated among APS rate classes under traditional cost allocation
and rate design principles and will be charged to customers taking competitive generation
service on a demand and/or energy basis, depending on the customer's class.